

BUILDING 21ST CENTURY NONPROFIT CAPITAL MARKETS: THE ROLE THAT DONOR-ADVISED FUNDS COULD PLAY

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Abstract: The structure and sources of capital available to nonprofit organizations largely fail to meet the financial needs of the sector. Given the dramatic growth of both the nonprofit and philanthropic sectors, the time to reinvent the “nonprofit capital markets” is now, and donor advised funds should play a leadership role in this process. This article outlines policies and practices with the potential to create new efficiencies in the delivery and investment of capital for the common good.

THE FINANCIAL STATE OF THE NONPROFIT SECTOR

Ask any nonprofit CEO what keeps her up at night, and the answer will likely have less to do with the problem her organization is trying to solve—such as hunger, poverty, homelessness or illiteracy, to name just a few—than it is finding the right amount and type of funding needed to fulfill the organization’s mission. Recently, the Independent Sector, the largest trade association serving both the nonprofit and philanthropic sectors, conducted a national outreach campaign to share the leading trends affecting the sector while engaging more than a thousand leaders in defining the problems and sharing promising solutions. While the sample does not pretend to meet standards of scientific rigor, the message heard from 12 different communities across the nation was resounding: their greatest challenge was achieving financial sustainability.

The consequences of this reality for our nation is captured by the Nonprofit Finance Fund (NFF)—one of the nation’s leading analysts and investors into the nonprofit sector—in the recently released findings from its seventh “State of the Nonprofit Sector” survey. While NFF reports that the data revealed “indications of recovery, stabilization and growth” in the sector, it also affirmed that “. . . many are confronting the troubling reality that current practices cannot sustain organizations in the long-term or meet the needs of the communities they serve now.”¹ The overarching conclusion of

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¹ Nonprofit Finance Fund, State of the Sector Surveys, <http://nonprofitfinancefund.org/state-of-the-sector-surveys> (2015).

this study is captured in the headline: “Recovery of the U.S. economy hasn’t addressed the systemic and perpetual funding challenges facing nonprofits.”²

It is time to assign the blame for this situation to where it belongs: the grossly inadequate systems that we use to capitalize and assess financial returns from nonprofit organizations. While there are countless organizations delivering cutting edge solutions for 21st century problems, they rely on “capital markets” whose practices too often harken back to the ways philanthropy was practiced a century ago—a profound irony for a nation whose private capital markets are arguably the most efficient in the world.

More than a decade ago, Bill Bradley and two directors from McKinsey & Company published a provocative article in the Harvard Business Review that argued the nonprofit sector could unleash \$100 billion “ . . . by challenging the operating practices and notions of stewardship that currently govern the sector.”³ The article succeeded in raising critical questions and recommending incremental improvements relative to the fundraising methods of nonprofits, philanthropic payout practices, and management capacity of the sector. The article estimated that in 1999 “ . . . the nonprofit sector actually spent \$36 billion to raise and deliver \$195 billion; that it is fundraising cost of approximately 18%, or about one dollar for every five dollars raised.”⁴ This compares to private sector cost of 10% or less to both pay for marketing and capital raising. The article recommended four approaches to improve this situation—on-line fundraising, associations, larger grants and *donor-advised funds*.

We can credit the authors with prescient thinking in two of these areas, as we have watched the extraordinary growth of both on-line fundraising and donor-advised funds. While overall trends in philanthropic giving have been flat for several years, the opposite is true of donor-advised funds. Contributions to donor-advised funds increased over 250% since 2009⁵ with recent trends forecasting equal if not greater rates of growth.

Yet, are these new sources of funding getting at the fundamental inefficiencies of our philanthropic marketplace? Four ingredients of our private capital markets that lead to their efficiency is transparency, universal access, standardized processes and aggregation of supply. On-line fundraising meets the first three of these criteria, but usually fails on the fourth if large, ongoing sources of capital are necessary, thereby doing little to reduce the

² *Id.*

³ Bill Bradley, Paul Jansen and Les Silverman, *The Nonprofit Sector’s \$100 Billion Opportunity*, Harvard Business Review, May 2003, at 1.

⁴ Bradley et. al, at 4-5.

⁵ Alan Cantor, “The Year in Review,” Alan Cantor Consulting Blog, December 16, 2014, (<http://alancantorconsulting.com/2014/12/the-year-in-review/#more-1877>).

overall financial or enterprise risk of a nonprofit, with significant consequences for performance and impact. Donor-advised funds fail to meet the first three, and are aggregated largely through the commercial gift fund industry whose business model relies largely on fees earned from investing the contributions in mutual funds and other investment products rather than the nonprofit sector.

THE UPSIDE-DOWN TAX POLICY

As we consider the status of donor-advised funds, we cannot avoid the tax benefits enjoyed by the donors. At the heart of the controversy over donor-advised funds is the reality that while donors realize an immediate tax deduction for their contributions, the tax code has no rule governing when these funds are distributed to charities. Since others have written about this inequity with great eloquence, I would like to offer a new perspective on this policy by comparing it to the Earned Income Tax Credit (EITC), arguably the most effective anti-poverty tax policy in the U.S.

The EITC rewards low-wage workers by providing tax refunds that enables millions of hard-working Americans to move above the poverty line. Worker typically receive their refund in a lump sum at tax time in what can be considered a direct exchange—recipients only “earn” the tax fund after they can document that they have been gainfully employed for some or all of the past year. The taxpayer receives the tax benefit after they have delivered on their part of the exchange.

This value proposition defines what good tax policy is all about. Policymakers decided that Americans who work full-time should not be poor, and provides targeted incentives to increase the financial security of households while also contributing to the growth of the broader economy as these households have enough income to meet basic needs and be more economically productive. It also targets tax incentives where they are needed most, moving millions out of poverty and into the economic mainstream.

Unfortunately, the same value exchange does not characterize the tax benefits “earned” by those who contribute to donor-advised funds given the absence of clear rules concerning how these contributions are distributed. It is this inconsistency that prompts the label “upside-down” tax policy; why should we provide the wealthiest Americans more generous tax benefits than we provide the lowest income citizens? Not only is this fundamentally unfair, but it also fails to stimulate the economic and social benefits for which philanthropy was invented.

BUILDING 21ST CENTURY CAPITAL MARKETS

Donor-advised funds are only part of the philanthropic industry to be reformed for the 21st century. One of the most positive trends is the recognition by funders themselves—some of whom operate donor-advised funds—that their practices need to change dramatically if they are to provide the type and amount of capital that will enable the nonprofit sector to thrive.

Four of the most promising practices underway include:

1. **Philanthropic Equity Grants**—with standard parameters, metrics, and social and/or financial returns distributed through a marketplace that pools a significant amount of philanthropic capital. This would supplement reserve and/or endowment grants by providing investment capital for current use, tied to specific outcome measures and investment needs, and classified as unrestricted.

2. **Nonprofit Finance Divisions of Investment Banks**—modeled on public finance departments, and supported in part by public and philanthropic funds (if necessary), these divisions would provide high performance and growing nonprofits with the financial design and engineering skills required to structure complex transactions without paying the standard prices.

3. **National Platforms for Socially Responsible Investment (SRI) Capital**—too much of SRI investments is housed in small boutique firms, with high transaction costs relative to the investment amounts. There is a large and growing market of high net worth individuals who would jump into this market if access was easier and more like investing in the stock market. State securities laws present significant barriers to creating economies of scale for individual firms; a national platform that addressed these legal barriers would have a potentially high return for the sector by attracting potentially billions in new capital priced below market.

4. **New Capital Collaborations with Public Sector Funding Sources**—from State Housing agencies to the CDFI Fund of the Department of Treasury, the true route to scale in low and moderate-income communities inevitably leads to the public sector whose subsidy dollars are essential to serving the lowest income Americans. The public sector is ripe for new, high profile capital collaborations that can be standardized and replicated by sector, by state or other framework. This approach also allows donors to focus on specific communities in which they live, or have strong ties, in a way that also promotes scale.

Donor-advised funds represent an opportunity to reinvent philanthropy to meet the needs of nonprofits. But we require policies and practices that meet the needs of the charities that they are designed to benefit. We must encourage these funds to adopt some of the practices that make our private

capital markets so effective in fueling the growth of our nation's businesses. We have the opportunity to marshal the financial, intellectual and strategic capital needed to both reduce the unconscionable inefficiency of current nonprofit funding methods while leveraging billions of new philanthropic dollars on behalf of the common good.

